

Subprime America Infects Asia and Europe

As the US real estate market collapses, questions about subprime mortgages and those unable to pay are in the news. These are not inconsequential questions. Over \$1.5 trillion of subprime—don't ask, don't tell—mortgages were issued and are now beginning to default.

As the defaults mount, the consequences will spread to countries and institutions far beyond the shores of the US and the desks of the originating lenders—for the majority of America's subprime loans are owned by investors, banks, insurance companies, and pension funds in Europe and in Asia.

Why Would Anybody Do Such A Thing?

It retrospect, it wasn't a good idea, *to wit*, to loan \$1.5 trillion without asking applicants how much money they had or how much money they made. It seems improbable that bankers (remember those thin-lipped disapproving loan officers) would loan money under those conditions. But they did and this is why:

One year after the collapse of the US stock market in 2000, the NASDAQ dropped 80% and the US government feared a deflationary depression—a no money no demand depression like the 1930s—could destroy the economy.

So in 2001 the US government took quick and decisive action—in retrospect stupid and short-sighted—and flooded the US with money to prevent a depression from developing; but, in the process they created a real estate bubble and, as the bubble deflates, those who can't pay their bills, aren't.

Banks aren't in business to loan money to those who can't repay them and they knew that customers who “took advantage” of subprime mortgages were at high risk of default. So the banks sold their subprime loans.

Now, who would buy a “subprime”, e.g. substandard, loan? Who would buy a subprime steak, a subprime car, a subprime house, a subprime dating service? This is where the genius of Wall Street came into play.

To sell these soon-to-explode debt bombs, Wall Street cleverly bundled them with higher rated AAA debt and gave them a new name, CDOs, collateralized debt obligations, and sold trillions of dollars of 30% subprime but AAA rated CDOs to unsuspecting buyers.

Even if you don't know what a CDO is, CDO sounds a lot better than subprime or substandard. That was the genius of Wall Street. It was a way for Wall Street to sell shaky debt before the fenders fell off. And it worked, at least for Wall Street.

These debt bombs are now embedded far across the global financial landscape, the majority bought by European and Asian investors and institutions seeking downstream

revenues; but instead of downstream revenues, they will be absorbing unexpected and significant losses.

Fully 50% of the 2006 earning of HSBC, The Hong Kong Shanghai Banking Corporation, the world's third largest bank, were wiped out by the subprime losses of its US subsidiary. AXA, a French insurance company and CommerzBank, a German Financial Services company were also major buyers of Wall Street's subprime AAA rated debt and will suffer the consequences for so doing.

But it was not only European and Asian banks, insurance companies, and hedge funds and pension funds that will suffer, wealthy Japanese investors may suffer the greatest losses of all. It is believed that the highest-yielding but riskiest tranches (risk level) of the subprime CDOs were bought by wealthy individual Japanese investors.

The head of structured finance research at Nomura Securities, Mark Adelson, said these investors did not fully understand the risk they were taking, depending instead upon the ratings given by credit agencies such as Moody's or the advice of those managing the security.

"A partial understanding of it is often no better than no understanding," Adelson said. "The devil is in the details; if you understand it vaguely, you can get your lights punched out."

Globalization has been a wealth builder, perhaps unequally so, but nonetheless wealth has been created. Soon, however, another darker side of globalization is about to manifest. Risk as well as money move quickly across global highways recently built and made possible by a one world financial marketplace, and that risk is now about to become apparent.

Global currency flows move swiftly and quickly and turn on a dime. The Asian liquidity crisis of 1997 was a recent manifestation of this phenomena; the next crisis will be the US. The subprime losses suffered by the buying of America's bad debts may be the final straw in the diversion of foreign moneys away from America.

By selling foreign investors its bad debt, America has shot itself in the foot. Because America is now the world's #1 debtor, because America needs over \$1 trillion in foreign investment capital each year to pay its bills—and because it was foreign investors that were primarily burned by Wall Street's subprime CDOs, the flow of foreign capital to the US may soon be going elsewhere.

In April 2007, a Merrill Lynch survey showed 38% of global money managers believed the best prospects for corporate profits were now in the eurozone, 42% believed the worst prospects were in the US.

Today, the word "de-couple" is increasingly heard where global markets are discussed. No longer referring to freight trains or dogs in *delicto flagrante*, de-coupling refers to the

distancing, i.e. de-coupling, of global economies from the US, to wit, *the increasingly perceived expeditious act or art of separating still-healthy economies from the slowing US economic engine.*

While it is true the US has been the driver of the global economy, it is no longer. The sobriquet “has been” is literally correct in this instance. The US share of global economic growth so far in 2007 is 10%, a figure analogous to Barry Bonds batting .134.

Global capital flows, like tsunamis, are not something to be taken lightly. If the flow of foreign money to the US slows, the US dollar will collapse and the US will be forced to raise interest rates to continue attracting foreign capital. And, if US interest rates are raised, the US economy will collapse. Greenspan might call this a conundrum. Other people might call it and Greenspan something else. Inflation is not the only problem America faces.

Whose feet?
Whose fire?

America apparently cares little what happens to the primarily foreign investors and institutions who bought its subprime loans. On April 24th, Bloomberg reported the head of the US Federal Deposit Insurance Corporation, Sheila Blair, testified before a congressional committee, “We should hold the servicers' and the investors' feet to the fire on this... We did not have good market discipline with investors buying all these mortgages.”

It is highly doubtful Ms. Blair will exhibit the same attitude should the flow of foreign moneys upon which Mr. and Ms. Average America depend go elsewhere. Thailand's economy went into apoplectic shock and its currency and stock market fell by 50% in 1997 when international currency flows suddenly changed direction. America may soon be in for the same.

And if America falters and falls, the consequences of such will be felt around the world. Today, afternoon tea and scotch flow freely in The City as does dim sum in Hong Kong and Shanghai and sushi in Tokyo around their respective bourses. Soon, however, the risks that have lain dormant beneath globalization's foundation are about to erupt and a reordering of the world's financial geography is about to ensue.

It's spring 2007 and the sun is shining in the US, backyard BBQs are being cleaned in anticipation of summer's use. A severe financial crisis, however, is in the offing; a crisis as unexpected as the Golden State Warriors' last minute streak to the NBA playoffs.

An unexpected financial crisis, however, will be much more consequential than Don Nelson's magical resurrection of the Warriors' NBA hopes. There, at least, the Warriors will have a fighting chance.

But because most people don't know a financial crisis is coming, they will have little chance of survival. This summer, America's subprime CDOs are coming home to roost, and not just to the US.

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